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7 ways to mess up your 401(k)

Not contributing at all is the biggest mistake people make, but there are others that can cost you substantially as well.

By Liz Pulliam Weston

In many ways, the 401(k) picture looks bright. Most folks who have access to a 401(k) take advantage of their workplace retirement plans. Average balances are up over the past few years. And workers seem to have finally gotten the message that company stock is not their best investment option. But millions of workers are still blowing it every day when dealing with their retirement plans. Here are the seven biggest blunders you can make:

1. Not signing up

I've seen a few awful 401(k) plans in my time. One was run by a dentist who forced his employees to help him buy raw land. (That was their only investment option.) Another offered only high-cost, poorly performing variable annuities with surrender charges that lasted 16 years, meaning workers often had to forfeit a good chunk of their money if they left their jobs and wanted to roll over their accounts.

But such truly heinous plans are few. Most participants get a decent range of investment options (17 choices is typical), reasonable fees and a company match. About 98% of the large-company plans that Hewitt Associates surveyed contribute to employee plans, with two-thirds offering matches.

There's simply no reason not to participate in a plan that's even halfway decent, yet one out of four eligible workers fail to sign up. Participation among young workers is even more dismal: Only 48% of those aged 20 to 29 are enrolled, according to Hewitt's survey of large plans. That's just dumb.

Average 401(k) account balances:

Age group*	1999	2006	Change
20s	$2,558	$28,248	1004%
30s	$17,277	$61,368	255%
40s	$50,147	$108,262	116%
50s	$82,059	$148,927	82%
60s	$121,982	$157,727	29%
All	$67,760	$121,202	79%

**Age of participant in 2006*

Source: Employee Benefit Research Institute (September 2007 report)

2. Missing out on the full company match

The typical large-company plan matches 50% of your contributions, up to 6% of your salary, Hewitt reports. Your match may not be as generous, but it still makes sense to take maximum advantage of what essentially is free money -- and 22% of you don't.

Don't think you can afford to contribute enough to get the full match? You're probably wrong. Each dollar you don't put into a company retirement plan is subject to federal, state and local income taxes. So if you're in a 30% combined (federal and state) tax bracket, each buck you toss into a 401(k) will reduce your paycheck by just 70 cents. If you're afraid of going whole-hog, just inch your contribution up each quarter by 1% more of your salary. Most people can compensate for the decreased income by bringing lunch from home one or two more times each week.

3. Taking too little risk

Most 401(k) investors seem to understand that stock and stock mutual funds are going to give them the best returns in the long run. About 68% of 401(k) assets were invested in equities in 2006, according to the Employee Benefit Research Institute (EBRI), which surveyed 53,931 plans covering 20 million participants. But about 15% of the participants EBRI tracked didn't invest anything in their available 401(k) stock choices.

It's understandable that some people would want to lighten up on stocks, either because they were approaching retirement or they learned they weren't quite as risk-tolerant as they thought. But few investors will be able to reach their retirement goals without any exposure to equities. Leading financial planners believe the average investor needs to keep at least half of his portfolio invested in stocks, regardless of age, if he wants an adequate income in retirement.

4. Taking too much risk

At the opposite end of the scale are the investors who overload on stocks. Nearly 40% put all or nearly all of their money into their 401(k) equity funds or into their company's stock, with little exposure to fixed-income investments.

During the go-go years, it was popular to opine that only old folks needed bonds. The stock market swoon, however, proved that most investors can benefit from the cushioning effect of bonds and cash. Many of the folks who panicked and cashed out at the bottom of the market might have been able to stand pat had they had some bonds adding value to their portfolios.

The classic balanced portfolio -- 60% stocks, 30% bonds and 10% cash -- is a good starting point for most investors. You can ratchet up the stock exposure if you're young or aggressive.

The risks of putting too much into company stock are so great that I'll give them their own section, otherwise known as:

5. Drinking the company Kool-Aid

In 1999, before Enron flamed out and took many of its workers' retirement dreams along with it, company stock made up 19% of 401(k) assets nationwide. According to EBRI, that percentage has since shrunk to 11%.

The Enron debacle pounded home the point that you do not want your retirement account riding on the same company that provides your job. Yet many people still falsely believe that their company's shares are somehow less risky than a diversified mutual fund.

Some 33% of workers who were offered company stock as an option put more than 20% of their 401(k) money there. That's a dramatic improvement from 1999, but there are still way too many folks overdosing on the company Kool-Aid. If you must invest in company stock, try to limit the overall investment to 10% of your balance. If your company matches your contributions with its own stock -- as Enron did and as others still do -- invest all of your own money elsewhere.

6. Taking out loans

What seems like a great idea -- Borrow your own money! Pay yourself interest! -- has plenty of traps for the unwary. The biggest pitfall is the risk you take should you lose your job. Your loan would become due, and, if you couldn't pay it back at once, you'd typically owe income taxes and penalties on the unpaid balance.

The interest rate you pay yourself may be lower than what you would pay most other creditors, but paying yourself interest is no substitute for the real return you would be earning if you had invested those payments instead.

Borrowing from your retirement funds, as nearly one in five workers do, according to EBRI, is often a sign that you're overspending -- particularly if you're using the proceeds to pay off credit card debt. People who use "easy outs" such as 401(k) and home-equity loans to pay off their cards often don't change the underlying behavior that put them in the hole. They just run up their balances again, winding up another day older and deeper in debt.

7. Cashing out

Next to not signing up, cashing out your 401(k) when you leave a job is the dumbest move you can make with a retirement plan. Yet 45% of the 160,000 401(k) participants Hewitt surveyed in 2005 did just that. The cash-out rates were highest among workers in their 20s. Nearly two-thirds of these workers raided their 401(k) accounts rather than rolling them over to individual retirement accounts or their new employers' plans.

They doubtless think they have years to save for retirement, so why not enjoy the cash now? But the younger you are, the bigger the price you pay for a 401(k) cash-out. That's because your money, had it been left alone, could have earned tax-deferred returns for decades. That $10,000 you cashed out at 25 could have netted you $200,000 or more in retirement cash, assuming an 8% average annual return and retirement at age 65.

Then there's the tax bite: Combined, the income taxes and penalties you pay typically equal a quarter to nearly half of your early withdrawal. Your 401(k) money isn't a windfall to be blown on vacations or cars or anything else that will be long forgotten by the time you're 65. This money may be all you have to live on. So treat it with some respect, people.

Liz Pulliam Weston's new book, "Easy Money: How to Simplify Your Finances and Get What You Want Out of Life," *is now available. Columns by Weston, the Web's most-read personal-finance writer and winner of the 2007 Clarion Award for online journalism, appear every Monday and Thursday, exclusively on MSN Money. She also answers reader questions on the* Your Money message board.